



FIRST DEVONIAN EXPLORATIONS LTD.

ANNUAL REPORT 1987

First Devonian Explorations Ltd. is a Calgary based Canadian controlled Corporation whose business is the exploration for, and the development and production of petroleum and natural gas reserves. The Corporation is solely involved in Western Canada.

First Devonian has evolved from a non-operating low interest holding entity to one which both operates and maintains a controlling interest in a majority of its programs. Prospects are usually generated by the Corporation and then outside participants are brought in who provide carried interests to First Devonian.

CORPORATE INFORMATION

HEAD OFFICE	Suite 380 622 - 5th Avenue S.W. Calgary, Alberta T2P 0M6 (403) 264-4405	LEGAL COUNSEL	MacKimmie Matthews Calgary, Alberta
DIRECTORS	R. Gordon Cormie Steven P. Dobrowolski Robert G. Jennings Sydney B. Loftus Wendy Posluns Lionel Robins Gary W. Selby Barbara Stitt Irving Teitelbaum	AUDITORS	Collins Barrow Calgary, Alberta
		REGISTRAR AND TRANSFER AGENT	Royal Trust Corporation of Canada Calgary, Alberta
		BANKER	National Bank of Canada Calgary, Alberta
OFFICERS	Steven P. Dobrowolski President Gary W. Selby Vice-President R. Gordon Cormie Secretary-Treasurer	STOCK EXCHANGES	Alberta Stock Exchange (FDI) Vancouver Stock Exchange (FDI)

ABBREVIATIONS USED:

Bbl	— Barrel
MBbl	— Thousand Barrels
Mcf	— Thousand Cubic Feet
MMcf	— Million Cubic Feet
m ³	— Cubic Metre
10 ³ m ³	— Thousand Cubic Metres
10 ⁶ m ³	— Million Cubic Metres

FIVE YEAR CORPORATE PROFILE

	1987	1986	1985	1984	1983
FINANCIAL					
Gross Revenues	\$1,596,094	\$1,741,525	\$ 1,369,889	\$ 970,762	\$ 605,889
Operating and Royalties	646,551	754,661	562,007	347,626	249,592
General and Administrative	266,154	278,890	183,943	195,351	192,150
Interest	227,479	171,697	108,306	101,286	58,981
Cash Flow	455,910	536,277	515,633	326,499	105,166
Earnings (Loss)	88,500	255,425*	122,039	74,897	(34,224)
Cash Flow per Share	.06	.12	.14	.10	.03
Earnings (Loss) Per Share	.01	.05*	.03	.02	(.01)
Working Capital (Deficiency)	(273,448)	(230,645)	(1,720,721)	(440,581)	(240,488)
Long-Term Debt	2,424,724	2,848,474	1,625,000	1,225,000	750,000
Capital Expenditures	312,196	1,965,930	2,717,526	1,008,337	899,986
Shareholders' Equity	2,168,897	2,080,397	3,439,263	2,802,193	2,630,456
Total Assets	5,769,615	6,840,210	8,513,566	4,847,065	4,105,425
RESERVES					
Proved and Probable					
Oil — Bbl	679,000	889,900	710,404	751,600	473,585
— 10 ³ m ³	108.0	141.5	112.9	119.6	75.3
Gas — MMcf	3,574	4,436	3,478	1,920	1,709
— 10 ³ m ³	101 200	125 600	98 470	54 381	48 396
OPERATIONS					
Daily Oil Production — Bbl	135	139	75	52	28
Daily Oil Production — m ³	21.4	22.2	11.9	8.24	4.47
Daily Gas Production — Mcf	335	101	171	161	161
Daily Gas Production — 10 ³ m ³	9.5	2.9	4.8	4.56	4.56
LAND HOLDINGS					
Canada — Net Acres	10,478	10,518	7,113	3,986	3,368
Canada — Net Hectares	4 242	4 259	2 878	1 612	1 362
ASSET VALUE					
15% Discount Factor					
Proven	8,092,000	8,436,000	9,090,000	8,246,300	6,429,200
Probable	568,000	1,424,000	2,408,000	1,389,000	1,381,800
Land	125,000	136,000	213,000	371,000	427,200
TOTAL	\$8,785,000	\$9,996,000	\$11,711,000	\$10,006,300	\$8,238,200

Number of Employees

5

6

5

5

4

*Before unusual items

REPORT TO SHAREHOLDERS

Fiscal 1987 was a period of consolidation for First Devonian Explorations Ltd. in the aftermath of the oil price fall in 1986. A number of measures were taken to position ourselves to again become a successful junior resource company.

The first step in solving any problem is the recognition of the factors giving rise to it. Obviously utilizing hindsight, we were able to determine that the Company was improperly financed in the event of an abrupt price collapse. The following actions were taken during the past year to correct this situation:

- 1) marginal properties in the U.S.A. and a minor interest in a shut-in gas property in Canada were sold. Effects of this have been to streamline operations and to reduce debt through the payout of a \$400,000 debenture;
- 2) emphasis continued to be placed on maximizing cash flow from existing properties with minimal investment. To that end, gas production commenced from our McBride gas field with minor tie-in costs, while a liquids facility was installed in the Virginia Hills Area at no cost to the Company; and
- 3) discussions were held with other entities to consider a potential financing and/or merger with First Devonian. A decision was ultimately reached to pursue a flow through financing which was completed subsequent to year end.

With the above steps taken, a revitalized First Devonian is now in a position to pursue oil and gas prospects and provide the exposure of a growth oriented company to its shareholders. We already have land holdings on prospects capable of development that have sizable reserve potential and other prospects mapped on which we hope to acquire a position.

With the ability to generate and operate quality drilling prospects combined with a relatively low overhead expense, we are advantageously positioned. Also, with specific expertise in a number of regions, First Devonian will continue to be competitive with the industry in a wide range of areas.

First Devonian's revenue fell by 8 percent to \$1,596,094 mainly due to the fact that the first half of our fiscal year's oil production was at a lower price than the prior year. Expenses fell in all categories except interest costs. Cash flow fell by 15 percent to \$455,910. Assuming that

product prices remain constant, our projected financial position for the upcoming fiscal year would include:

- 1) an increase in revenue due to higher oil and gas sales along with a greater amount of income generated through management and operator's fees;
- 2) similar relative production, royalty and general and administrative expenses as 1987 with reduced interest costs as our total debt declines;
- 3) a relative decrease should occur in our depletion and depreciation charges as our reserve base grows; and
- 4) a net overall increase in cash flow and earnings should result.

Oil production for fiscal 1987 remained somewhat constant declining by 3 percent to 135 barrels per day. No additional oil wells were drilled. Gas production was up by 232 percent to 335 Mcf per day. One multizone gas well was drilled in McBride which has yet to be tied in.

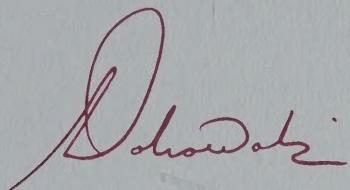
On October 21, 1987, First Devonian closed a \$2,000,000 flow-through issue at \$0.25 per share with funds to be spent prior to February 28, 1989. Flow-through funds are to be used for exploratory and development drilling along with land acquisitions. CEDIP government grants, estimated to exceed \$500,000, will be retained by the Company. Associated tangible expenses are to be funded through cash flow and bank financing. As operator, on behalf of First Devonian and others, we will now embark on a drilling program of approximately \$12,000,000.

Concurrent with the closing of the flow-through financing, a participation agreement was signed with an investor whereby up to \$2,000,000 per annum for a 5 year period may be spent through First Devonian. Advantages to the Company of this participation include certain management fees and an expanded program with the control that higher working interests bring.

First Devonian is in the unique position of being financed for over a year's time and intends to carefully select areas for investment, with a view to having a self sustaining entity at the completion of the program. The past two years have taught us the limitations of any firm belief in financial forecasting; however, with current pricing and based on historic finding costs, we feel that this objective is attainable.

Although dramatic increases in reserves and production, and outstanding financial results are not part of this report, we are pleased at our overall improvement in corporate health. Over time, this deliberate performance should accelerate. We wish to voice our appreciation to staff and investors who have contributed to this improved position.

Submitted on behalf of the Board of Directors.

A handwritten signature in dark ink, appearing to read "Dobrowolski".

Steven P. Dobrowolski
President

November 6, 1987

EXPLORATION AND DEVELOPMENT

First Devonian's 1987 fiscal year had minimal drilling activity. Only one multizone gas well was drilled in Canada which consolidated our position in the McBride gas field. Of more interest to shareholders would be our plans for the upcoming winter drilling season upon which we will elaborate.

DRILLING RESULTS

	For the Fiscal Year Ending In				
	1987	1986	1985	1984	1983
Canada:					
Oil	0	7	10	4	6
Gas	1	1	4	0	0
Dry	0	2	3	0	1
Injector	0	0	1	0	0
Total	1	10	18	4	7

MAJOR PROPERTIES

The Company's objective will continue to be to develop existing low-risk properties in Western Canada so as to immediately enhance cash flow and we expect to maintain this goal in any acquisition of new lands.

McBRIDE, ALBERTA

A separate seismic anomaly offsetting our McBride gas field is scheduled to be drilled this year in an attempt to increase reserves and deliverability in the area. The existing field is productive from four separate formations and one of our three wells is now producing.

First Devonian holds an interest in 4,320 gross (1,188 net) acres in the McBride Area. The Company also holds an option on an additional section in the nearby Stanmore Area which we may elect to drill and earn if an upcoming seismic program indicates that it is warranted.

VIRGINIA HILLS, ALBERTA

A liquids recovery facility was installed at no cost to First Devonian at our Virginia Hill battery over the past summer months. After initial start-up problems, the facility is now producing 45 barrels of liquids per day. The Company has a production sharing agreement covering this incremental liquids production with the investors that put up the facility costs. We may also pipeline in the

existing gas production of 275 Mcf per day to which we have retained full rights. The gas is currently being flared after the liquids are stripped out. Oil production averaged 288 gross (66 net) barrels per day in Virginia Hills during fiscal 1987.

Our program calls for drilling an additional well in Virginia Hills and implementing a waterflood project. This would bring the total number of producing Beaverhill Lake oil wells to seven in the area with one injector. An attempt to complete a shallow zone in a suspended well will be undertaken.

The Company operates land holdings of 7,040 gross (1,630 net) acres in Virginia Hills.

SWAN HILLS, ALBERTA

The drilling of at least one location is planned in the Swan Hills Area this winter. We will also be reworking certain wells in the area in an attempt to improve productivity. The results of the drilling and rework program will determine whether additional locations exist on the Company's lands.

First Devonian produced 66 gross (39 net) barrels of oil per day from 6 oil wells in the Swan Hills Area during fiscal 1987. We operate lands totalling 3,520 gross (1,750 net) acres in the area.

JUDY CREEK, ALBERTA

Subsequent to its year end, First Devonian increased its land holdings in the Judy Creek Area to 2,720 gross (964 net) acres. We are attempting to further increase our land position in this area prior to drilling a location. The potential exists in Judy Creek for discovery of a feature similar in nature to our Virginia Hills property. The ultimate reserve and productivity characteristics of this prospect make it one of the most exciting ventures that First Devonian will undertake in the near term. We currently operate two oil wells in this area which produced at a rate of 119 gross (22 net) barrels per day last year.

RESERVES AND PROPERTY VALUES

An evaluation of the Company's reserves effective July 31, 1987 was conducted by in house engineering personnel. The following significant revisions were made:

- 1) reserves were reduced by the sale of a shut-in gas property in Wilson Creek and by the sale of marginal producing assets in the U.S.A.;
- 2) changes were made based on the year's actual production rates and operating expenses with the major revision being the reduction of ultimate forecasted recoverable oil reserves in the

Swan Hills Area; and

- 3) incremental proven reserves were added in the Virginia Hills Area due to the planned implementation of a waterflood scheme.

The following table illustrates First Devonian's estimated net oil and gas reserves and future cash flows after the deduction of royalties, overrides, operating and capital costs, and mineral taxes. Alberta royalty tax credit is included in our forecasts and all cash flows are before corporate taxes.

ESTIMATED RESERVES AND CASH FLOW

Reserve Category	Reserves					Present Value Of Future Cash Flow (M\$)				
	Gas		Oil			0%	10%	12%	15%	20%
	10^6m^3	MMcf	10^3m^3	MBbl						
Proven	83.9	2,962	99.9	628.3	19,255	10,333	9,269	8,092	6,639	
Probable	17.3	611	8.1	50.7	1,843	792	690	568	425	
Sub-Total	101.2	3,574	108.0	679.0	21,098	11,025	9,959	8,660	7,064	
Undeveloped Land					125	125	125	125	125	
TOTAL					21,223	11,150	10,084	8,785	7,189	

The above represents the estimated potential value of the Corporation's oil and gas properties assuming no risk is attached to the forecasts.

With its recent financing, First Devonian will again begin to develop high quality oil and gas reserves situated principally in Alberta. While most expenditures will be in areas in which we are currently established, we also expect to begin to have limited exposure in new areas with similar characteristics.

First Devonian's net asset value at a 15% discount factor declined slightly from \$6,258,931 in 1986 to \$6,031,618 in fiscal 1987. With renewed drilling activity, we will again re-establish a pattern of growth in the Company's value.

NET ASSET VALUE

Asset Value (15% Discount Factor - 50% of probable reserves)		\$ 8,501,000
Plus: Notes and Long Term Receivables	\$ 228,790	
	\$ 228,790	\$ 228,790
		\$ 8,729,790
Less: Long Term Debt	\$ 2,424,724	
Working Capital Deficiency	273,448	
	\$ 2,698,172	\$ 2,698,172
NET ASSET VALUE:		\$ 6,031,618

PRODUCTION

Oil production rates reflected the limited drilling activity of the Company. Rates fell by 3 percent to 135 barrels per day as no new oil wells were brought into production. The decline in rates was not severe, reflecting the longer term nature of most wells.

Gas production increased sharply by 232 percent as the first well in the McBride Field was placed on stream. We expect further improvements in this area as additional wells remain to be tied into pipelines and a full year's production was not recorded in 1987.

Overall production rates of oil and gas will begin to rise after our second quarter as results of our flow through program begin to be seen. We are pleased to see some stability in our production and a more balanced position between oil and gas production from a variety of sources.

NET OIL AND GAS PRODUCTION

	For the Fiscal Year Ending In				
	1987	1986	1985	1984	1983
Daily Oil Production — Barrels	135	139	75	52	28
Daily Gas Production — Mcf	335	101	171	161	161

AUDITORS' REPORT

To the Shareholders
First Devonian Explorations Ltd.

We have examined the consolidated balance sheet of First Devonian Explorations Ltd. as at July 31, 1987 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at July 31, 1987 and the results of its operations and changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Alberta
October 16, 1987

COLLINS BARROW
CHARTERED ACCOUNTANTS

CONSOLIDATED BALANCE SHEET

JULY 31, 1987

1987

1986

ASSETS

Current assets		
Accounts receivable	\$ 902,546	\$1,680,694
Notes receivable (note 2)	47,800	54,050
Long-term receivables (note 3)	180,990	—
Property and equipment (note 4)	4,638,279	5,105,466
	\$5,769,615	\$6,840,210

LIABILITIES

Current liabilities		
Bank overdraft	\$ 76,988	\$ 25,192
Accounts payable and accrued liabilities	699,006	1,109,897
Current portion of long-term debt (note 5)	400,000	776,250
	1,175,994	1,911,339
Long-term debt (note 5)	2,424,724	2,848,474

SHAREHOLDERS' EQUITY

Share capital (note 6)	2,080,397	6,730,286
Retained earnings (deficit)	88,500	(4,649,889)
	2,168,897	2,080,397
	\$5,769,615	\$6,840,210

Approved on behalf of the Board,

D. Shandor, Director

R. Gordon Morris, Director

CONSOLIDATED STATEMENT OF EARNINGS
YEAR ENDED JULY 31, 1987

	1987	1986
Revenue		
Oil and gas sales	\$1,316,967	\$ 1,460,655
Alberta royalty tax credit	172,594	108,464
Operator's fees and other	106,533	172,406
	1,596,094	1,741,525
Expenses		
Production	416,925	517,807
Royalties	229,626	236,854
General and administrative	266,154	278,890
Interest on long-term debt	227,479	171,697
	1,140,184	1,205,248
Working capital generated from operations	455,910	536,277
Charges not requiring working capital		
Depletion	295,000	220,600
Depreciation	72,410	60,252
	367,410	280,852
Earnings before unusual items, income taxes and extraordinary item	88,500	255,425
Unusual items		
Write-down of petroleum and natural gas leases and rights in Canada	—	3,098,700
Write-down of petroleum and natural gas leases and rights in the U.S.	—	1,811,600
	—	4,910,300
Earnings (loss) before income taxes and extraordinary item	88,500	(4,654,875)
Deferred income taxes (recovered) (note 9)	33,000	(196,300)
Earnings (loss) before extraordinary item	55,500	(4,458,575)
Extraordinary item		
Income tax reduction resulting from utilization of loss carry-forward	(33,000)	—
Net earnings (loss)	\$ 88,500	\$(4,458,575)
Earnings (loss) per share before extraordinary item	\$ 0.01	\$ (0.96)
Earnings (loss) per share after extraordinary item	\$ 0.01	\$ (0.96)
Cash flow per share	\$ 0.06	\$ 0.12

CONSOLIDATED STATEMENT OF RETAINED EARNINGS
YEAR ENDED JULY 31, 1987

	1987	1986
Deficit, beginning of year	\$ (4,649,889)	\$ (191,314)
Deficit offset against share capital (note 7)	4,649,889	—
Net earnings (loss)	88,500	(4,458,575)
Retained earnings (deficit), end of year	\$ 88,500	\$(4,649,889)

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
 YEAR ENDED JULY 31, 1987

	1987	1986
Operating activities		
Earnings (loss) before extraordinary item	\$ 55,500	\$(4,458,575)
Items not involving cash		
Depletion and depreciation	367,410	280,852
Deferred income taxes (recovered)	33,000	(196,300)
Write-down of oil and gas properties	—	4,910,300
Cash flow from operations	455,910	536,277
Net change in non-cash working capital balances	(8,993)	(1,298,066)
Working capital deficiency acquired on purchase of subsidiary	—	(1,204,654)
Cash flow (deficiency) from operations available for investment	446,917	(1,966,443)
Investing activities		
Acquisition of property and equipment	(442,896)	(1,989,397)
Petroleum and other incentive payments	130,700	23,467
Acquisition of subsidiary	—	(210,000)
Cash used in investing activities	(312,196)	(2,175,930)
Financing activities		
Proceeds (repayment) of long-term debt	(423,750)	1,223,474
Issuance of share capital	—	3,303,563
Share capital issuance costs	—	(203,854)
Repayment of notes receivable	6,250	11,200
Increase in long-term accounts receivable	(180,990)	—
Disposal of property and equipment	411,973	—
Cash provided (used) by financing activities	(186,517)	4,334,383
Increase (decrease) in cash	(51,796)	192,010
Bank overdraft, beginning of year	(25,192)	(217,202)
Bank overdraft, end of year	\$ (76,988)	\$ (25,192)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JULY 31, 1987

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company are stated in Canadian dollars and have been prepared in accordance with accounting principles generally accepted in Canada which, in the case of the Company, conform in all material respects with International Accounting Standards. The significant accounting policies are summarized below:

a) Principles of consolidation

The consolidated financial statements include, in addition to the accounts of the Company, the accounts of its wholly-owned subsidiaries, First Devonian Explorations Inc., Barracuda Petroleum Inc., and 497394 Ontario Ltd.

b) Exploration and development costs

The Company follows the full cost method of accounting for exploration and development expenditures, wherein all costs related to the exploration for and the development of oil and gas reserves are initially capitalized. Costs capitalized include land acquisition costs, geological and geophysical expenditures, rentals on undeveloped properties, costs of drilling productive and non-productive wells, together with overhead and interest directly related to exploration and development activities. Proceeds on minor property sales are credited to the net book value of the property and equipment. Gains or losses on major property sales are normally recognized in the statement of earnings.

Exploration and development costs are allocated to two cost centres, namely, Canada and the United States.

Costs capitalized in the cost centres are depleted on the composite unit-of-production method based on estimated proven oil and gas reserves as determined by independent and Company engineers.

In applying the full cost method, the Company performs a ceiling test which restricts the capitalized costs less accumulated depletion and depreciation for each cost centre from exceeding an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves, based on current prices and costs, and after deducting estimated future general and administrative expenses, financing costs and income taxes for each cost centre. In calculating the above cost centre ceiling tests, gas was converted to oil on a 7 MCF to 1 BBL equivalent basis and \$26.00 Canadian per barrel of oil was used as the current price of oil.

c) Depreciation

Lease and well equipment are depreciated on the composite unit-of-production method. Other equipment is depreciated on the declining balance method at 20% per annum.

d) Joint venture accounting

Substantially all of the exploration and production activities of the Company are conducted jointly with others and accordingly these consolidated financial statements reflect only the Company's proportionate interest in such activities.

e) Net earnings (loss) per share

Net earnings (loss) per share has been calculated using the weighted average number of common shares of 8,363,503 outstanding during the year. The conversion of the convertible demand debenture would not be materially dilutive.

f) Cash flow per share

Cash flow per share refers to working capital generated from operations, and it has been calculated using the weighted average number of common shares of 8,363,503 outstanding during the year.

g) Foreign currency translation

The Company follows the temporal method of translation whereby foreign currency accounts and operations are translated to Canadian dollars on the following basis: monetary items at the rate of exchange at the year-end; other assets and liabilities at the historical rate of exchange. The items in the statement of earnings are translated at the average rates of exchange prevailing during the year except for depletion and depreciation, which are translated at the same rates as used for the related assets. Material translation gains and losses on monetary items are included in the statement of earnings.

h) Accounting for changing prices

No procedures have been adopted by the Company to reflect the impact on the financial statements of specific price changes, changes in the general level of prices, or both.

2. NOTES RECEIVABLE

Pursuant to share purchase options exercised, the Company has advanced funds to certain employees to enable them to purchase common shares from treasury. The advances are non-interest bearing, are secured by promissory notes and are due on or before April 10, 1988. It is the opinion of management that repayment terms of the notes receivable will be extended, therefore notes receivable have been classified as long-term assets.

3. LONG-TERM RECEIVABLES

Long-term receivables are due from certain officers and employees, are non-interest bearing and have no fixed terms of repayment.

4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	Cost	Accumulated Depletion and Depreciation	Net Book Value	
			1987	1986
Petroleum and natural gas leases and rights including exploration and development thereon	\$7,067,894	\$3,475,200	\$3,592,694	\$4,107,475
Lease and well equipment	1,814,383	798,000	1,016,383	962,579
Other equipment	84,979	55,777	29,202	35,412
	<u>\$8,967,256</u>	<u>\$4,328,977</u>	<u>\$4,638,279</u>	<u>\$5,105,466</u>

During the year, the Company capitalized general and administrative expenses in the amount of \$162,123 (1986 - \$241,079) and interest on long-term debt in the amount of \$40,143 (1986 - \$57,232).

5. LONG-TERM DEBT

Long-term debt is comprised of the following:

	1987	1986
Bank production loan	\$1,700,000	\$2,500,000
Non-convertible demand debenture	400,000	400,000
Convertible demand debenture	724,724	724,724
	<u>2,824,724</u>	<u>3,624,724</u>
Less: Portion due within one year	400,000	776,250
	<u>\$2,424,724</u>	<u>\$2,848,474</u>

- a) The bank production loan bears interest at one percent over a Canadian chartered bank's prime lending rate and is secured by a \$5,000,000 floating charge debenture over the assets of the Company, a general assignment of book debts, an assignment of accounts receivable, an assignment of shares of the Company's subsidiaries, an assignment of certain monies under a specified contract and by certain oil and gas properties.

The estimated principal payments due on the bank production loan are as follows:

1988	\$ —
1989	—
1990	460,000
1991	480,000
1992	480,000
Subsequent to 1992	<u>280,000</u>
	<u>\$1,700,000</u>

- b) The non-convertible demand debenture bears interest at one percent over a Canadian chartered bank's prime lending rate and is secured by certain oil and gas properties. Subsequent to July 31, 1987, the Company retired the non-convertible demand debenture in full with a cash payment of \$400,000.
- c) The convertible demand debenture is convertible, at any time, into 4,706,000 common shares of the Company and is secured by certain oil and gas properties. The debenture is non-interest bearing unless the debenture holder makes demand for repayment, at which time the debenture will bear interest at one percent over a Canadian chartered bank's prime lending rate. At the present time, the debenture has not been demanded for repayment.

The management of the Company does not anticipate that the convertible demand debenture holders will demand principal repayments within the upcoming fiscal year. As a result, the convertible demand debenture has been classified as a long-term liability.

6. SHARE CAPITAL

- a) Authorized

Unlimited number of voting common shares without nominal or par value
 4,706,000 Class A voting shares without nominal or par value
 1,110,113 First preferred non-voting shares without nominal or par value

- b) Issued

	1987	1986
8,363,503 Common shares	\$6,205,454	\$6,205,454
4,706,000 Class A shares	471	471
1,096,278 First preferred shares	<u>1,096,278</u>	<u>1,096,278</u>
	<u>7,302,203</u>	<u>7,302,203</u>
Less: Deficit offset against share capital (note 7)	(4,649,889)	—
Share issuance costs	(571,917)	(571,917)
	<u>\$2,080,397</u>	<u>\$6,730,286</u>

- c) The Class A shares were issued to investors in conjunction with the \$724,724 convertible debenture (note 5). The shares are redeemable from time to time either upon the repayment of all or a portion of the outstanding principal amount of the convertible debenture or upon conversion of the Class A shares into common shares of the Company, on a basis that one Class A share will be redeemed for each portion of the outstanding principal amount of the convertible debenture equal to \$0.154 which is either repaid or converted into common shares.
- d) The first preferred shares bear a 10% non-cumulative dividend accruing, upon declaration, from and after July 31, 1986. The shares are retractable at a retraction value of \$1.00 per share at the option of the holder after 5 years at a rate of 5% of the initial number of such shares held by each holder per year for the next ensuing 10 years and at the rate of 10% of such shares per year for the ensuing 5 years. In addition, the shares are fully redeemable by the Company at a redemption value of \$1.00 per share at the option of the Company at any time.

7. DEFICIT OFFSET AGAINST SHARE CAPITAL

At the annual general meeting on March 11, 1987, a special resolution was passed which authorized a reduction of the Company's share capital by the amount of the deficit as at July 31, 1986 pursuant to Section 36(1) of the Business Corporations Act (Alberta).

8. RELATED PARTY TRANSACTIONS

The Company has a participation plan whereby certain officers and employees are allowed to participate up to a total of 10% of the Company's working interest in new ventures. Participation is on standard industry terms.

9. INCOME TAXES

Income tax expense, comprised exclusively of deferred income taxes, differs from that which would be expected from applying the effective Canadian federal and provincial income tax rates to earnings before income taxes. Details of the changes are set out below:

	1987	1986
Effective Canadian income tax rate	47%	47%
Computed "expected" income taxes (recoverable)	\$ 41,595	\$(2,170,300)
Increase (decrease) in income taxes resulting from:		
Tax benefit not recognized on the write-down of petroleum and natural gas leases and rights due to a lack of virtual certainty of realization	—	2,021,800
Non-deductible crown payments, net of Alberta royalty tax credit	4,610	43,300
Resource allowance and earned depletion	(7,755)	(91,100)
Other — U.S. revenue	(5,450)	—
Deferred income taxes (recovered)	<u>\$ 33,000</u>	<u>\$ (196,300)</u>

10. SUBSEQUENT EVENT

Subsequent to year-end, two agreements were entered into whereby the Company is committed to issue 8,000,000 "flow-through" common shares at \$0.25 per share during the period from October 21, 1987 to February 28, 1989. The funds to be received from the issuance of these shares must be spent on qualifying expenditures as defined in the Income Tax Act. Under the terms of agreements, all government grants earned that relate to these qualifying expenditures are to be retained by the Company, and the Company must renounce \$2,000,000 of tax write-offs, net of any government grants, to the investors during this time period.

11. SEGMENTED INFORMATION

The Company operates exclusively in the oil and gas industry and as such is defined as having a dominant industry segment. During the year, all the property and equipment in the United States cost center was sold or abandoned, leaving the Company with a single cost center, namely Canada.

12. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform with current year presentation.

